

# The Facts of Fraud: What Your Clients Should Know

By Ryan D. Stretmater, CPA/CFE, CFE, MBA

**F**raud may not be the most pleasant topic, but it is certainly not one to gloss over when advising clients on business matters.

Instances of fraud can happen in any organization, especially when it comes to asset misappropriation, which accounts for more than 85 percent of occupational fraud. Managers and lower-level employees are most often responsible for this type of theft – of which 80 percent involves theft of cash – and the results can be devastating. Each year, the typical organization loses 5 percent of its revenues to fraud.

Unfortunately, the impact of fraud tends to ripple beyond the initial theft. Organizations may lose their upstanding reputation along with the support of donors or stakeholders. Employee morale can quickly plummet. Worse yet, approximately half of victim organizations do not recover any of their fraud-related losses.

Why would an employee commit such a crime? Three factors – together known as the fraud triangle – typically come into play: pressures, rationalization and opportunity.

Pressures may be extenuating circumstances such as personal financial hardships. Rationalization refers to how the individual may justify his or her actions. Perhaps an employee feels as if he or she deserves a larger paycheck. While attempting to control these two factors is impractical, business owners can control opportunity. Increasing the threat of detection, thereby reducing the perceived opportunity, is one of the most effective elements of fraud prevention.

Nevertheless, many organizations, particularly small to midsize businesses, forgo several key anti-fraud controls. Business owners may think the costs outweigh the benefits or view them as yet another over-



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head expense. These attitudes are partly due to a lack of understanding. So, to help your clients gain perspective on fraud, here are a few facts they should know.

**There is no immunity.** No business or organization is immune to fraud. Additionally, perpetrators come from all levels of authority and often from a position of trust. When an employee is found to have embezzled cash, the response from the business owner is often “he’s the last person I thought would do this!” While the banking and financial services industry has the highest rate of reported fraud (17.8 percent), industries such as government and public administration (10.3 percent), manufacturing (8.5 percent) and health

care (7.3 percent) follow closely behind.

**External auditors won’t necessarily catch it.** Many organizations make the mistake of assuming external auditors will uncover any fraud. Auditors, however, are not responsible for finding every instance of fraud. An auditor’s duty is to obtain *reasonable*, but not absolute, assurance about whether the financial statements are free of *material* misstatement. Auditors are not responsible for finding instances of fraud under a certain threshold, which is a matter of professional judgment. It is also possible for a material fraud to go undetected despite a properly performed audit.

**Other employees might not report it.** Many business owners think if fraud hap-

pens in their office, they will hear about it. Needless to say, this expectation is not always accurate. In many instances, employees don't raise the alarm about fraud because they simply don't know how to report it. Younger employees in particular may be anxious about the ramifications of blowing the whistle on a senior member of the organization. For this reason, business owners should consider training employees to recognize warning signs of fraud, and they should make reporting these signs easy and completely anonymous. A well-advertised fraud hotline, for example, is a fantastic way to promote a culture of "if you see something, say something."

**Insurance won't always cover it.** Business owners should know that certain insurance policies cover employee dishonesty or theft, whereas others do not. These policies typically include two types of coverage: (1) coverage for the upfront cash loss (i.e., the theft); and (2) coverage for claims expense, or the cost of investigating and quantifying

the loss. It is prudent to ask your clients if this type of coverage is in place. While this insurance is not an anti-fraud policy, it is a key component of a disaster recovery plan and can prevent a business owner from joining the slew of victim organizations unable to recover a single penny of their fraud-related losses.

**If your client experienced fraud, would you know?** Your clients should be prepared to immediately take action if they discover indicators of fraud. Their first order of business should be to place a call to your office. As their counsel, you are the person who is best positioned to direct the response plan, which may necessitate the involvement of a forensic accountant.

Proactively sharing these facts with your clients is a great way to help them understand their vulnerability to fraud and the impact it could have on their organization. Doing so also helps to drive home an important point: If your clients were to experience fraud, they can always call you.

Source: "2014 Report to the Nations on Occupational Fraud and Abuse" issued by the Association of Certified Fraud Examiners.

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